

FEBRUARY 2010



Eastern Michigan Real Estate Investment Association

E.M.R.E.I.A. ADVISOR



Next Monthly Meeting

Date: Thursday, February 11, 2010

Time: 6:30 p.m. - 8:30 p.m.

Place: M-TEC building, SC4 campus

Guest: Randy Fernandez, City of Port Huron

Mary Bowers, Evergreen Appraisals

William Fealko of Fletcher, Fealko,
Shoudy, Moeller, P.C.

Topic: Property Tax Appeals

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Notice

- If you wish to see an article pertaining to a certain subject or if you would like to publish one, please contact Julia at the main office.
- In attempt to decrease costs and paper waste, we will now send your newsletter to your email if we have your address on file. If you need to update your address or wish to continue receiving a paper copy of the newsletter, please let us know as soon as possible. jtyrrell@innovativehousing.org

Frozen Pipes; What Do You Do Now?

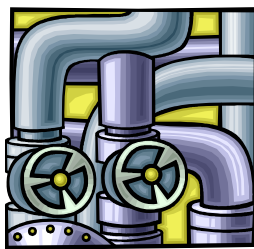
It is now the winter time. It's freezing outside. In this economy, if you are like me, you have more vacancies than you have had in years. Nobody is in those apartments during this weather.

You may have a unit in which either the former tenants or one of the repairmen had shut off the furnace or you did not have automatic switchover of the gas to your name when the tenant moved out. I had both of these situations happen to me recently.

Both happened with lower units. I had been periodically checking the units. When the outside temperature was in the twenties and thirties, the basement and the heated upper apartments kept the units in the balmy fifties, which is where the thermostat was set. I had no reason to suspect that there was no heat in the apartments. However, when the outside temperature went to single digits for days on end, it was a different story.

In the first situation, I went to the apartment one evening on my way home from work. Every faucet was frozen solid; no handle would move. In the bathroom, there was no water in the toilet bowl or tank, it was only ice.

I decided that since it was obviously frozen solid it would take some time to thaw the pipes, so I kicked on the heat and went home to change into my apartment work clothes. By the time I got back to the apartment only two hours later, it was obvious that pipes had burst. Water was flowing from the ceiling in the kitchen over the kitchen cabinets and in a hallway over carpeting. There was over a foot of water in parts of the basement.



I quickly shut off the water mains and then had to go home again to get my boots, pump and other water clean up materials. I spent the better part of the night getting the water out of the basement and drying out the apartment.

The next morning, I called Watson Brothers to schedule a time to fix the water pipes that had burst. I learned something new in that telephone call.

I was told that the pipes generally do not burst when they are frozen, but when they are thawing. The hydraulic pressure builds up in the pipes as the ice is melting and it creates such high pressures that it

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can literally blow the pipes apart as it did in my case. There were three pipes that burst in my unit, two were just split down the side, but the third was literally blown apart. It looked like an explosive had been put in the pipe.

I was told that the best way to minimize the risk of bursting pipes is to shut off the water main and open up all of the faucets before you turn up the heat and start thawing the pipes. This way, you reduce the build up of hydraulic pressure in the pipes during thawing and you may prevent the pipes from bursting.

As luck would have it, the same day, I discovered the same thing in another one of my units. Just like the first one, all of the faucet handles were frozen solid and the toilet and tank were blocks of ice. The gas could not be turned on for three days so I brought in my ceramic heaters to heat up the apartment. I first shut off the water main. I then put one heater in the bathroom, one in the kitchen and one in the basement, in an attempt to thaw the pipes. As soon as the handles on the faucets moved, I opened up all of the faucets.

In a matter of a few hours, I was able to turn the water main back on and all of the faucets were running freely with full pressure. However the toilet bowl and tank were still blocks of ice. It took another two days for the toilet and tank to thaw. By the time the gas was turned on, everything was thawed and running freely.

I was able to save all the pipes in the second apartment and needed Watson Brothers only to repair the pipes in the first unit. Lesson learned and noted.

MATTHEW M. WALLACE



The spices & seasonings of the gourmet real estate investor.

Emeril can't figure out where he made his mistake. He thought he was getting a great deal when he bought a house and got a 10% discount. However, he barely turned a profit on his investment.

Julia also is completely stumped. She bought a house with a 25% discount. However, after selling the property, Julia lost money.

Any cook can try to cover up a bad chicken with salt, pepper, oregano, lemon, paprika and more, but what do you have? Still have a BAD CHICKEN DINNER.

In the same light, a real estate investor who starts off with too small a discount on their purchase can try to make up for it after the purchase with hard work, fancy improvements, and eye-catching advertising. However, what will they still have? Usually, they will still have a BAD INVESTMENT.

So what are the right spices and seasonings (discounts) every gourmet real estate investor should know about? How should they be applied like gourmet chefs Emeril Lagasse and Julia Child?

There are four key spices and seasonings that every gourmet real estate investor should know about and understand how to apply. The four key discounts make up the Total Investor Discount and are listed below:

- Minimum Investor Discount
- Repair and Improvement Discount
- Negative Property Attribute Discount
- Length of Time on the Market Discount

MINIMUM INVESTOR DISCOUNT

The first is the Minimum Investor Discount (MID), which is the minimum profit an investor should receive from any real estate investment. So, what is the minimum profit an average real estate investor should get? 10%? 25%? Perhaps 50%?

The answer is... it depends on your real estate investment strategy.

If your strategy is "buy and flip," then all of your profits come from the difference in the purchase costs (purchase price, repair costs, marketing cost, etc.) and the sales price. The differential is your only profit source. Because there is the risk that a property may not sell quickly, many "buy and flip" investors require a 25% or more MID.

If you're going to use the "buy and hold" strategy, which usually means you're going to rent your property, then you have access to multiple profit sources. These investors have access to the same profit source as the "buy and flip" investors. However, they make much of their profit over an extended period of time from rental payments, appreciation of the property, equity gains from paying down the loan with the tenant's money, and tax write-offs. The pure "buy and hold" landlord has a total of five profit sources. Therefore, their Minimum Investor Discount can be as low as 5-10%.

Finally, if you're going to "buy and lease/purchase" your property, then you usually have access to the same five profit sources

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INVESTOR DISCOUNT - continued from pg 4

as the “buy and hold” investor. However, you also gain access to another profit source, option money (the leasee/purchaser pays this for the right to buy your property at a later time). With lease/purchases, you need to keep in mind that your property may sell quickly and you may not have access to these other five profit sources. Accordingly, “buy and lease/purchase” investors often need a Minimum Investor Discount in between the “buy and flip” and “buy and hold” discounts. Therefore, they often need a Minimum Investor Discount of 10 - 20%.

Emeril and Julia both got reasonable discounts, 10% and 25%, respectively. However, they did not make a satisfactory return on their transactions. What happened? Recognizing the appropriate Minimum Investor Discount for your chosen investment model is a good first step. Emeril actually received the right MID for his lease/purchase strategy... 10%. However, when the house took longer to lease/purchase due to some problems he failed to consider and the house sold one year later, he only made \$1,000. Julia got an even better discount... 25%. However, when it took her nine months to sell the property, she lost \$10,000.

So, where did they go wrong? They used only one of the four spices and seasonings in the Total Investor Discount. A successful real estate investor uses all four, as needed, to make sure their purchases are always savory.

REPAIR AND IMPROVEMENT HASSLE DISCOUNT

The second of the four key discounts is the Repair and Improvement Hassle (RIH) Discount. The basic concept to understand here is that an investor should not complete repairs and improvements that the seller is either unwilling or unable to complete without additional compensation. The investor is assuming risk that the repairs and improvements might be more excessive and costly, the investor is paying the mortgage or finance costs while the repairs and improvements are being completed, and of key importance the investor's time and energy to get these done has VALUE. The rule of thumb we apply is an additional discount of 1% for every 3% of repairs and improvements as a percentage of the value of the property fixed up.

Emeril's property was worth \$200,000 fixed up, and required \$48,000 worth of repairs and improvements. Therefore, for Emeril's property, \$48,00 of repairs equals 24% of the fixed up value. Repairs and improvements of 24% are fairly significant. Emeril had to bear a decent amount of risk, and likely spent a good amount of time managing his contractors. Accordingly, the additional RIH Discount should have been 8% (1% for every 3% or 24% / 3%).

Julia's property had a fixed up value of \$100,000 and repairs and improvements of \$15,000. Here the repairs and improvements represent 15% of the fixed up

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value, and her RIH should have been 5% (15% / 3%).

NEGATIVE PROPERTY ATTRIBUTE DISCOUNT

The third key discount can be one of the trickiest. Simply put, a Negative Property Attribute (NPA) is a problem with a property that cannot be eliminated with repairs and improvements. A good example is a home without a basement, located in a subdivision where basements are common. Another example is the first home in a subdivision that borders a main thoroughfare. Even if this home was offered for free, there would still be many families with children who would not even consider this home.

A property's NPA is often the main reason that a property is available at a discount. Therefore, if an investor does not in turn consider a proper additional discount to begin with when buying the property, they run a risk of severely impacting their profits and even losing money. How does an investor account for NPAs? The investor does this by asking a critical question: "how difficult will this attribute make it for me to rent, lease/purchase or sell this property?"

Emeril's property was missing a basement in a neighborhood filled with basements, so the NPA Discount should have been 3-5%. Julia's home bordered a busy street and was on a very steep hill, so her NPA Discount should have been around 6-8% (3-4% for the busy street and 3-4% for the very steep driveway). The more

properties you work with, the more you will get comfortable with the appropriate additional NPA Discount specific for each investment.

Can an investor simply decide to avoid properties with NPAs? Sure, this is possible, but the main concern here is that this will reduce the investor's pool of available investment properties. Most of our best deals come from properties that have NPAs. The reason is that these attributes turned off most buyers, leaving investors who know what they're doing as the most likely purchasers of these properties. The key is not to avoid properties with NPAs, but rather to properly account for the NPAs within your Total Investor Discount.

LENGTH OF TIME ON MARKET DISCOUNT

The final of the four key investor discounts is the Length of Time on the Market (LTM) Discount. The theory here is actually quite simple. The longer a home has been on the market, the more likely there are additional issues to deal with. For one, if the property has been vacant for a long period of time, it may have developed problems from lack of use (pipes may freeze over and spring leaks, lack of air circulation can cause molding, etc.). Additionally, the longer a property is for sale, the more chance that a negative reaction in the community becomes attached to it. Accordingly, when you go to sell it, rent it or lease/purchase it, you may have to discount it to overcome this bad stigma. The good news is that it is often easier to negotiate big discounts on properties that

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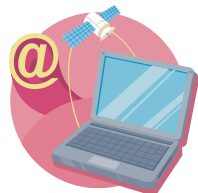
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sit on the market for long periods of time because their owners tend to be anxious to sell them.

So, how much additional discount should an investor get for a house that sits on the market for an extended period of time? Our rule of thumb is 1% for every month over two months up to 10%. What this means is that we've found that a typical residential property should get a contract on it within two months. After that, the negative stigma begins to attach, vacant houses begin to suffer and sellers and their agents become more anxious. Commercial listings are generally longer and more complicated, so the investor often should not begin adding 1% until after the 3rd or 4th month that the property has been on the market.

Emeril's property was on the market for four months, so he should have received an additional LTM Discount of 2% (for months number 3 and 4). Julia's had been on the market for five months, so she should have received an LTM Discount of 3% (the steep hill and busy street were most likely impacting it).

TOTAL INVESTOR DISCOUNT

Now you know the special spices and seasonings to make gourmet real estate investments. When applying them, we simply add up the four discounts to determine the Total Investor Discount (TID) we need in order to make the property a winning investment. We then multiply this percentage by the Fair Market Value of the property in repaired and improved condition (based on comparable surrounding properties).

Emeril obtained a \$20,000 discount on his investment that he valued at \$200,000 (fixed up). However, he paid too much. Yes, he got his MID of 10%, but he did not include the RIH of 8%, NPA of 4%, and LTM of 2%. In actuality, his TID should have been \$48,000 (24% x \$200,000).

In the same light, while Julia got a \$25,000 discount on her real estate purchase, she also paid too much. Yes, she received her MID of 25%, but did not get the RIH of 5%, NPA of 7%, and LTM of 3%. Therefore, her TID should have been \$41,000 (41% x \$100,000).

Now you might be asking yourself, what if my repair, improvement, and holding costs exceed my TID? The answer... it doesn't matter. As an investor, you should be compensated additionally for these. In other words, the price you pay should not exceed the Fair Market Value (of the property in fixed up condition) minus all costs and your TID, what we call the Maximum Purchase Price or Ceiling Price. If the price exceeds the Ceiling Price, then you're likely making an unsavory real estate investment.

Finally, Emeril and Julia's properties may seem like more trouble than they're worth. But, when we see properties like theirs, we instantly begin to smell the simmering profits and prepare for another gourmet investment. This is because most buyers like properties with little or no problems. Therefore, sellers are usually willing to substantially discount them. Emeril and Julia may have been able to get the appropriate TID, if they had been patient, and if not, they should have moved on to other properties. As you can now see, we look forward to finding properties with problems and adding the right spices and seasonings (discounts) to cook up another gourmet investor meal.

Good luck and happy cooking!

Real estate investors need exit strategies. You make money when you buy, but you collect the profit when you exit.

Investing is part art, part science so deciding which exit strategy is best for a “fixer upper” or other property before buying is critical. The right choice will contribute to a positive outcome.

With a home that needs repair, six common exit strategies are:

1. Fix and flip
2. Fix and hold long-term
3. Fix and hold short-term
4. Wholesale with no fix
5. Wholesale with a variety of levels of repair or fix
6. Hold with a lease option tenant

To find the best exit strategy, consider these important variables:

Systems and Expertise

If you have expertise in a particular area of rehabbing, you may choose to systematize and repeat that strategy. For instance, if you have 12 years of wholesaling experience and almost unlimited demand for your properties, you may wholesale nearly all of your deals “as is” with no “fix” involved.

If you are a new investor with few contacts and little money or credit, you may decide to fix and flip the first few deals to build capital. Regardless, experience, agility, skills and knowledge can help you thrive as an investor in any market.

Access to Cash and Credit

With limited access to cash and credit,

flipping and wholesaling, rather than holding, may be wiser. No cash or credit? Wholesaling may be the only option. If you have cash and want to put it to work for the long-term, you are a natural for holding quality properties.

The Local Market

If prices in a particular market or sub-market continue to fall, then wholesale deals or quick flips usually make more sense than holds. If prices in the area are near bottom, then holding a property after rehab could make sense, particularly if others are afraid to enter the market. Other people’s ignorance and fear are your best friends in investing.

The first 12 months emergence from a bear market offers unique opportunities because the crowd is still afraid to invest.

Time vs. Profit

Lack of time/profit analysis is a common error made by investors. Taking a \$8,000 wholesale fee could be better than the great \$70,000 rehab that makes you only \$30,000 and ties up your time, cash, and credit for months. Because the variables of time, profit and unexpected headaches, you must be adaptable and figure the value of your time when deciding to hold, fix or wholesale. What is the cost of one larger, longer project against smaller, faster turns?

Deal Availability

This directly relates to time vs. profit. If the deals are scarce, you will more likely flip than wholesale. If good deals are falling from the sky, enjoy the ride and wholesale like crazy! Similarly, you should consider the availability of end buyers

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for the deals. If deals are plentiful but your list of end buyers to purchase them is short, you could open up the flood gates by flipping a home retail. This may allow you more time to build up a better investor list for future wholesaling opportunities.

Terms of the Deal

Limited access to cash and credit, the deal terms and financing involved can make one exit strategy more preferable than the other. If you acquire a property subject to existing financing in an area where rent payments will easily cover the payment, a long-term hold makes sense. On the other hand, if the property has significant equity, then flipping should turn into the most profitable route.

Charting and analyzing the above factors will help determine the best strategy. Be agile as the initially chosen exit could change as the market, terms, or your situation changes. Flipping may be your initial choice on a property but then a better deal could be discovered. Then what? Only rigorous analysis will answer the question.

Case Study

Consider a single-family home in Las Vegas, NV. The media is neutral about real estate even though many lender-owned properties (REOs) are selling rapidly. Rents are weaker but, due to present low purchase prices, most investment grade properties cash flow. Assume a sample property is purchased with borrowed private money (9% interest, 3-year loan) for \$56,000 with an "after repair" value of \$90,000 (prior value in 2007 was \$178,000). This property needs \$10,000 worth of rehab. Rented, the property will cash flow monthly at \$380 after the loan payment, taxes, insurance, and property management are deducted.

Our sample buyer is very new to investing and has no cash or credit except for the private lender. Another third party investor has offered to pay \$7,000 over the initial \$56,000 purchase price "as is" and will fund this closing with cash.

Analysis: Even though Las Vegas appears to be a good city for long-term holds, wholesaling the property without rehab is the best strategy. Flipping is the next best strategy as it would net around \$25,000 after rehab rather than \$7,000 pre-rehab. Since our sample buyer is a new investor, a \$7,000 profit with no risk of a rehab getting out of control is a great option. If the investor were more experienced with rehabs, then perhaps flipping would make more sense. Holding when you have limited cash or credit is almost never the right strategy.

Availability of private money in the future is important as well. If, for example, the private money in our illustration is available solely for this deal, then a lease option or long-term hold would be one of the best options. It may be better to use that money, keep the property, and gain a few years' worth of cash flow and price appreciation than to sell now and not have full use of these funds.

It is easy to see from this case study that your cash, credit, experience, time, and ability to find deals is important in determining your exit strategies. As an investor, you need to increase your skills and knowledge, find additional cash and credit, and leverage others to work more great deals. Easier said than done? Getting educated and becoming involved in a network of investors can greatly improve your success- and your profits.

From *The Voice*, November 2009

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MATTHEW M. WALLACE, C.P.A., J.D.

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701 HURON AVENUE, SUITE 102
PORT HURON, MICHIGAN 48060

www.wallaceplaw.com
matt@wallaceplaw.com

(810) 985-4320
FAX (810) 985-4108

The OPPLIGER LAW FIRM

DAVID E. OPPLIGER
ATTORNEY AND COUNSELOR

1111 PINE GROVE AVENUE
PORT HURON MI 48060
(810) 966-1881 • FAX: (810) 966-1893
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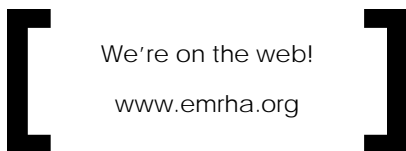
Eastern Michigan Real Estate
Investment Association

3051 Commerce Dr, Ste 5
Fort Gratiot, MI 48059

Phone: (810)385-2332

Fax: (810)385-8875

Email: jtyrrell@innovativehousing.org



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E.M.R.I.E.A. ADVISOR

Our office is located at:

3051 Commerce Dr, Ste 5
Fort Gratiot, MI 48059

Phone: (810)385-2332

Fax: (810)385-8875

www.emrha.org

Office Hours:

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